The Old System of Railroad Regulation

By Samuel O. Dunn
Editor of the *Railway Age*

PUBLIC regulation and private ownership and operation of railroads was the policy of the United States until the end of the year 1917. The early regulation, except in some of the states, was neither comprehensive nor effective. The passage of the Hepburn act, which became a law in 1906, marked the commencement of really effective regulation by the federal government. At about the same time most of the states began passing laws and creating or strengthening railroad (or public utility) commissions, with the result that comprehensive and effective regulation by the state and the federal governments began almost simultaneously.

Throughout the period of effective regulation, and, indeed, for years before, there was much agitation, on political and economic grounds, for government ownership and operation. Government operation was adopted at the beginning of 1918 as a war measure. The advocates of government ownership hailed its coming as the death-knell of private management. Most of the advocates of private management also thought we had seen the last of that policy. They feared the difficulties in the way of a return to private operation would be insuperable.

The country has now (in September, 1919) had twenty months of government operation. President Wilson has announced that on January 1, 1920, we shall return to private operation. No large class of persons is in favor of a continuance of government operation. The leaders of the railway labor brotherhoods are advocating government *ownership;* but even they are opposed to government *management.* They favor the so-called "Plumb Plan," under which, while the public would buy the railroads, it would delegate their management to a board, one-third of whose members would be appointed by the President of the United States, one-third by the "official employes" of the railways, and one-third by the "classified employes." This is not the place

to present or discuss the reasons why government operation has proved unpopular. The patent fact is that it has proved very unpopular.

But the decision to return to private operation does not solve our perennial "railroad problem." If the government should simply hand the roads back, they would automatically be subjected to the old system of regulation. Everybody is opposed to that also. It is but stating the simple truth to say that that system as it stands today has no friends. People differ as to what its faults are; but all agree that it has great faults.

The Senate and House Committees have held long hearings on the railroad problem. Nobody has appeared to oppose all changes in the present system of regulation, while numerous plans for making great changes in it have been presented. The Esch-Pomerene bill, which it is understood was practically drafted by the Interstate Commerce Commission, and the Plumb Plan, which is supported by the leaders of the railroad labor organizations, represent the two extremes of conservatism and radicalism. Between them lie the plans of the National Association of Owners of Railroad Securities, the Association of Railway Executives, and the Transportation Conference of the Chamber of Commerce of the United States, as well as some plans proposed by individuals. It would be a great achievement of statesmanship for Congress to select the good features of all these plans and weld them into a single piece of constructive legislation.

The old system of regulation has tried to accomplish numerous purposes. The most important have been the following:

1. To abolish unfair discriminations between shippers and communities.
2. To improve railway service, and especially to increase the safety of the service.
3. To bring about peaceful settlements of labor disputes.
4. To stop financial abuses in the management of the railroads.
5. To secure low rates.

Nobody will question that regulation should try to accomplish all these purposes. There is another purpose which it is now contended in many quarters should expressly be made one of its principal objects. This is the adequate development of railroad facilities.

PREVENTION OF UNFAIR DISCRIMINATIONS

Less than fifteen years ago the purpose for which a stronger system of regulation was chiefly advocated, was the suppression of unfair discriminations between shippers and communities. These discriminations included the giving of secret rebates on freight and of free transportation to passengers. There were also many unfair discriminations between shippers and communities in the published tariffs.

Two methods were adopted to abolish unfair discriminations. Secret rebating and the giving of free passes except to specified classes of persons were prohibited under severe penalites. The strict enforcement of these prohibitions has produced the desired effects.

The other method used for abolishing unfair discriminations has been that of requiring all rates to be published and filed with the state and federal commissions some time before going into effect, and of empowering the commissions to change unfair rates either by fixing the exact rates or the maximum rates which must be charged. Unfair discriminations in the published tariffs have been in these ways largely reduced, although not completely abolished. Experience has shown that a regulating commission, in order to enable it completely to abolish unfair discriminations, must be empowered not merely to fix maximum rates, as the Interstate Commerce Commission is, but to fix the *exact* rates, or the minimum as well as the maximum rates to be charged. One of the changes in the act to regulate commerce recommended by the Interstate Commerce Commission is that it shall be given power to fix minimum rates. This recommendation undoubtedly ought to be adopted.

UNFAIR DISCRIMINATIONS AND ENFORCED COMPETITION

The necessity for giving the Commission authority to fix minimum as well as maximum rates, in order to enable it to stop all unfair discriminations, arises chiefly from competition between the railways. One of the anomalies of the old system of regulation has been that it has dealt with the railways both as if they were naturally quasi-monopolistic and as if they ought to be highly competitive. Because of their quasi-monopolistic character it subjects their rates to regulation by the Interstate Com-

merce Commission. At the same time, under the Anti-Pooling law and the Sherman Anti-Trust law, it attempts to enforce unrestricted competition between them in making rates, as well as in other matters.

In consequence there is still some competition in rate-making between the railroads. It occasionally happens that an individual road fixes a rate on a particular commodity or to a particular community which is lower than the rate authorized by the Interstate Commerce Commission and relatively lower than the rates on other commodities or to other communities. Railroads competing with this road have no means of preventing it from taking such action, since the law prohibits all agreements and combinations between competing roads. The result—whether other lines meet the reduction in rates or not—is an unfair discrimination, which not only injures the shippers or communities affected but also all the competing railways.

While the Interstate Commerce Commission should be given authority to fix minimum rates, it is now agreed by all recognized authorities that laws which seek to enforce competition in rates should not be continued in effect. These laws originally were intended to prevent the railroads from entering into agreements to make and maintain excessive rates. Later legislation having empowered the Interstate Commerce Commission to reduce any rate which is excessive, and to prevent any advance in rates which would be so, the only effect now produced upon rates by the Anti-Pooling law and the Sherman Anti-Trust law is to foster unfair discriminations.

DISCRIMINATIONS DUE TO REGULATION

While regulation has greatly reduced the number of unfair discriminations, many have arisen as a direct result of it. This has been due to the fact that rates have been regulated by both state and federal authorities independently of each other. In numerous cases state legislatures and commissions have fixed rates which were lower than corresponding interstate rates sanctioned by the Interstate Commerce Commission, the effect being unfair discrimination against interstate commerce. In the *Shreveport case* the United States Supreme Court held that where a rate fixed by a state worked an unfair discrimination, the Inter-

state Commerce Commission could correct the discrimination even by changing the state rate. In order to enable it more effectively to deal with such discriminations the Interstate Commission has recommended legislation authorizing it in appropriate cases to conduct hearings jointly with the state commissions and enter a decision upon a single record which would be binding upon all affected. The measure proposed by the Commission doubtless would remedy unfair discriminations due to our dual system of regulation.

REGULATION TO IMPROVE SERVICE

The second purpose mentioned above as having been sought by the old system of regulation, has been that of improving railway service, especially in respect to safety of operation. The attainment of this object also has been attempted by means of both express legislative requirements and the orders of commissions. Many years ago Congress passed a law requiring a certain percentage of all locomotives and cars to be equipped with power brakes and automatic couplers, and empowered the Interstate Commerce Commission to increase the percentage that must be so equipped as conditions warranted. This legislation has been successful, and all railway equipment now has the safety appliances then specified by law. Later Congress authorized the Interstate Commerce Commission to prescribe all the kinds of safety appliances which should be used upon locomotives and cars. The Commission, after conferences with officers of the railways, issued orders which have caused practically all locomotives and cars to be equipped with uniform safety appliances.

Some of the federal legislation to promote safety, as administered by the Commission, has been of more questionable value. The Commission was authorized to and did issue an order requiring all railways to use high power headlights on their locomotives. The Commission's order has been severely criticised by the officers of railways handling a heavy traffic upon multiple tracks, upon the ground that while high power headlights on railways with single tracks promote safety, their use is dangerous on railways with multiple tracks. It is generally agreed, however, that most of the regulation of railway equipment and operation by the federal government has been beneficial.

The same thing cannot be said respecting much or even most of the regulation of operation by the states. Many of the states have adopted so-called "full train crew" laws fixing the minimum number of men that must be employed on trains. It is claimed that this has resulted in forcing the railways to employ more men than are needed, has not promoted safety, and has caused economic waste.

There have been not a few examples of duplication, and even conflict, between state and federal regulation of operation. It has been contended with much force that as every large railway operates in more than one state and most of them in several states, and as the requirements for handling state and interstate traffic safely and economically are the same, practically all power of regulating operation should be concentrated in the federal government.

THE PROPOSED TRANSPORTATION BOARD

The Association of Railway Executives and some other important business organizations favor the creation of a Federal Transportation Board, to which should be transferred all the purely administrative functions now performed by the Interstate Commerce Commission, and to which should also be delegated such additional administrative functions as may be given to any federal authority. It is contended that it is not only contrary to our constitutional form of government, which is based upon the principle of a division of legislative, administrative and judicial functions, but contrary to public expediency, to unite in one body the semi-judicial and the administrative functions now performed by the Commission. The Commission, it is said, is primarily a judicial body and is well qualified so to adjust railway rates as to prevent unfair discriminations and to cause each class of traffic to bear its fair share of the total cost of transportation. Being, however, primarily a semi-judicial body, it is unfitted, it is contended, to perform such purely administrative functions as that of regulating operation. Furthermore, it is contended, the Commission already is overloaded and would be still more overloaded if a large part of the regulatory functions now performed by the state authorities were transferred to it. It would be much better able to fix rates equitably and satisfac-

torily if all such administrative functions as those of regulating operation and enforcing the laws against the railways were transferred to a Federal Transportation Board. Besides, it is argued, the administrative work of regulation would be better done if it were all turned over to a purely administrative body such as a Transportation Board.

COMPETITION AND RAILROAD SERVICE

Reference has been made to the effects the laws to prevent agreements or combinations between competing railways have had upon rate-making. These laws have had even more striking effects upon operation and service. While there have been exceptions, the railways usually have made the maximum rates fixed by the Interstate Commerce Commission the exact rates they have charged. In consequence the rates between the same points by different railways usually have been the same. When the rates charged by competing roads are the same, the only inducement a railway can offer a shipper or traveler to use its line is superiority of service. Intense competition in service has therefore been one of the main characteristics of railroad operation in this country. This competition has been very unequal because of differences in length of lines, gradients, financial strength, etc., and the "strong" roads have year by year captured an increasing part of the business. While this intense competition has tended to improve the service it has resulted in large wastes. The railways would have reduced the intensity of the competition and avoided many of these wastes, if the law had not prohibited them from entering into any agreements or combinations.

While there long had been criticism of the laws to enforce unrestricted competition, it took the crisis of the great war to bring the public to an appreciation of the more disastrous effects which they were apt to produce. Soon after the United States entered the war, the chief executives of the railways, at the suggestion of the Council of National Defense, formed an organization headed by the Railroads' War Board, to coördinate for war purposes the operation of all the railroads. At every step it took, this voluntary organization encountered obstacles created by the laws designed to compel unrestricted competition. Immediately after the government took control of the railroads, the Director

General suppressed all competitive activities upon the ground that they would interfere with the most efficient use of the railroads in the war.

Few people favor the complete abolition of competition in railroad service. It is generally agreed, however, that there has been too much competition, and that the railroads should be authorized to make any agreements or combinations which the federal authorities may hold will not be prejudicial to the public. It is regarded by most students of the railroad problem as desirable that many combinations of "weak" roads with "strong" roads shall be formed in order that in future competition in service shall be carried on only between large and strong systems. Most of the important "plans" which have been submitted to Congress authorize railroad combinations under the supervision of the government. It is even proposed in some quarters that combinations shall be made compulsory. Some of the leaders of public thought who favor voluntary combinations, and also some who favor compulsory combinations, believe they should be formed under the supervision of the proposed Federal Transportation Board. Others are in favor of giving supervision over them to the Interstate Commerce Commission.

SETTLEMENT OF LABOR CONTROVERSIES

The third purpose above mentioned which regulation has sought to accomplish, is that of securing the peaceful settlement of controversies between railways and their employes. There are now practically no state laws dealing with railway labor controversies. The only federal law is the Newlands act. It provides for a Mediation and Conciliation Board of three government officers. When a dispute arises which may lead to an interruption of transportation, this board may tender its services as mediator to both sides. If mediation fails, the controversy may be submitted to arbitration by a board composed of two representatives of the railroads, two representatives of the employes, and two representatives of the public. The companies and employes are not required to arbitrate, but if they do, they are bound to abide by the award for a limited period.

For some years this law—previous to its revision known as the Erdman act—proved an efficient means of settling labor contro-

versies. But it finally broke down completely. The arbitrators representing labor and the companies always became advocates of their respective interests. This rendered it necessary for the representatives of the public to decide the awards. The leaders of organized labor claimed that the awards were never fair to their followers, and in 1916, when the four brotherhoods of train service employes demanded that eight hours should be made the basis of a day's wage and that they should be paid time and a half for overtime, they refused to submit their claims to arbitration in any form. The controversy was carried to the White House. President Wilson asked the railway managers to grant the basic eight-hour day, but they refused to do so unless after arbitration. The heads of the labor organizations issued an order for a strike. President Wilson recommended to Congress the establishment of the basic eight-hour day by statute, and only the passage of the Adamson act prevented a strike.

After government operation was adopted the Railroad Administration created a "Board of Railroad Wages and Working Conditions," to which the claims of all employes for changes in wages and working conditions are referred. It is composed of three railway officers and three representatives of railway employes. It can only hold hearings and make recommendations to the Director General. As long as the country was at war this Board succeeded in agreeing upon the recommendations to be made to the Director General, and about $700,000,000 of the $1,000,000,000 increases in wages granted under government control were based upon its reports. The spokesmen of the employes used the seemingly successful work of this Board as an argument for the creation of wage boards composed of equal numbers of officers and employes as a permanent solution of the problem. Early in 1919, however, the railway shop crafts presented to the Board of Railroad Wages and Working Conditions claims for a large increase in wages in addition to those which had already been given them. All the representatives of the employes on the Board favored granting the demands, while all the railway officers opposed it. It would appear, therefore, that the theory that all railway labor disputes can be amicably and satisfactorily settled by boards of adjustment composed equally of officers and employes, also has now fallen to the ground.

Numerous new methods of settling labor controversies have been suggested. One of these is that, after the railways are returned to private operation, several boards of adjustment shall be created which shall be composed equally of representatives of the railway companies and of the employes. Every controversy shall be submitted in the first instance to one of these boards. If a majority of its members agree, its award shall be final. If not, the Federal Transportation Board which it is proposed shall be created, shall organize a board of arbitration composed of equal numbers of representatives of the officers, the employes, and the public, to which the controversy shall be appealed; no strike or lockout shall be permitted in any controversy until after it has been arbitrated. Some advocate requiring the Interstate Commerce Commission to fix all railroad wages and working conditions as well as all rates. The Commission has indicated, however, that the task of settling labor controversies would not be welcomed by it.

The old system of regulation provided no efficient means of settling labor controversies, nor did it in any way correlate the regulation of wages and the regulation of rates. One of the most difficult problems Congress will encounter in trying to frame a new system of regulation will be that of adopting satisfactory and effective means of settling labor disputes and of having the settlements promptly taken into account in the regulation of rates.

REGULATION OF SECURITY ISSUES

No other charge ever made against them has done the railway companies of the United States so much harm as the oft-repeated allegation that they are enormously over capitalized. In view of the many and bitter attacks which have been made upon the companies upon this ground, it is a remarkable fact that the federal government has never attempted to regulate the issuance of their securities, and that until recent years few of the states did so. Apparently the first state which authorized its railroad commission to regulate the issuance of securities was Massachusetts. This was about a quarter of a century ago. Within the last twelve years about twenty states have begun regulating securities. It not infrequently happens now that a large rail-

road system must get the permission of a half dozen state commissions before it can issue any stocks or bonds to raise money, and such permission is given in most, if not all, of the states only after application, notice, hearing and deliberation by the commission. The railroad company may desire to use the money to be raised by the sale of the securities to improve its facilities and service in all the states it traverses, but a single state may prevent it from issuing them or delay their issuance until a favorable time for selling them is past.

The existing situation is admitted on almost all hands to be very unsatisfactory. Exclusive federal regulation is now advocated by the railway executives, the Interstate Commerce Commission, and most of the state commissions. Some eminent lawyers claim, however, that the federal government cannot assume exclusive authority to regulate the securities of corporations created by state laws, and therefore advocate the passage of a federal law requiring all railroad companies to take out federal charters. Some other lawyers contend that the federal government cannot compel a state corporation to take out a federal charter. Still other lawyers claim that the federal government can without federal incorporation assume exclusive regulation of securities issued by railroad companies doing an interstate business as properly incidental to the regulation of interstate commerce. That legislation empowering some federal tribunal to regulate the issuance of railroad securities will be passed seems highly probable, but it also appears probable that there will be important litigation before it will be determined just what form such legislation must finally be given in order to be constitutional. Those who advocate the creation of a Federal Transportation Board, favor delegating to it rather than to the Interstate Commerce Commission, the function of regulating the issuance of railroad securities.

EFFECT OF REGULATION ON RAILROAD DEVELOPMENT

While other effects produced by the old system of regulation have been the subject of a good deal of discussion, no other has been and is now the subject of so much discussion as its effect on railroad profits. Spokesmen of the railroad labor brotherhoods recently have charged before the House Committee on Inter-

state Commerce, that the owners of the railroads, by selling stocks on a bonus basis, padding the property investment accounts, watering capitalization, and other means, have derived large profits from the railroads which have been made illegitimately at the expense of the public and the employes. Some members of the Interstate Commerce Commission have claimed that under the old system of regulation the railroads were allowed to earn adequate net returns, and one member has especially called attention to the fact that in the last three years of private control, 1915, 1916, and 1917, the operating income of the companies was larger than in any preceding three years.

On the other hand, the spokesmen of the railroad companies claim that under the old system the companies were not allowed to earn adequate returns and that this resulted in a sharp decline in the development of transportation facilities. They contend that the principal purpose for which our system of regulation should be radically changed is that of adapting it to the promotion of the adequate development of railroad facilities. One of the principal duties of the Federal Transportation Board whose creation they advocate would be to keep informed as to the country's transportation requirements and certify to the Interstate Commerce Commission from time to time the amount of earnings the railways of each section need to enable them to give good and adequate service. The Transportation Board's certification would be binding upon the Commission unless conclusively shown to be erroneous.

Some other organizations advocate going even farther than the Association of Railway Executives. The National Association of Owners of Railroad Securities has proposed legislation to provide that the Interstate Commerce Commission must permit the railways of each large traffic section to earn an average of at least 6 per cent upon their book cost of road and equipment. Any road which earned more than this would be required to divide the excess, keeping one-third itself, paying one-third into the federal treasury, and distributing one-third among its employes. The Transportation Conference of the Chamber of Commerce of the United States has proposed legislation requiring the Interstate Commerce Commission to fix rates which will yield an average of 6 per cent upon a fair valuation of the railroads. Any

road which earned more than 6 per cent would be required to put part of the excess into a contingent fund of its own and part into a general contingent fund, these funds to be used if necessary to make up deficiencies in earnings in lean years. It also favors the creation of a Transportation Board to promote the adequate development of transportation facilities.

HAVE RAILROAD PROFITS BEEN SUFFICIENT?

It is most important to determine whether or not under the old system of regulation the railroad companies were denied opportunity to earn adequate net returns. The railroad companies have to compete in the world's market for capital against concerns of other kinds. Insufficient net earnings will render them unable to meet this competition for capital. If they are not able to raise their share of new capital they will be unable adequately to develop their facilities, and without sufficient transportation facilities the development of the commerce of the country will gradually be brought to a stand.

Now, it is true, as has been pointed out by one member of the Interstate Commerce Commission, that the operating income of the companies in the last three years of private control was the largest in *gross amount* in history. But it was not the largest relatively, for it yielded only about $5\frac{1}{4}$ per cent upon the railways' book cost of road and equipment. Besides, it is easily demonstrable that under the old system of regulation the general tendency of railroad profits was to decline seriously. The book cost of road and equipment is the basis used in the reports of the Interstate Commerce Commission for computing the percentage of net return earned. The Commission's statistics show that following the railways' recovery from the effects of the panic of 1893, the percentage of return earned steadily increased until 1906. There was a sharp decline after the panic of 1907, followed by a recovery which continued until 1910. In the five years ended with 1900 the percentage of operating income on book cost of road and equipment was 3.82 per cent; in the five years ended with 1905, 4.97 per cent; and in the five years ended with 1910, 5.41 per cent. It was in the year 1910 that the railroads started the first important proceeding for general advances in rates. This was based chiefly upon the ground that increases

of labor costs were rendering it impossible to earn reasonable profits. The advance in rates was denied. Most of the advances in rates asked for within the next five years also were denied. In this five years the average percentage of return earned was only 4.56 per cent, and in 1915 it reached the lowest point since 1899, being only 4.09 per cent. In the years 1916 and 1917 there was a sharp upturn in operating income, the percentage earned in these years being almost 6 per cent. But this was due to an unprecedented increase in traffic caused primarily by the war in Europe and secondarily by this country's entrance into the war. If there had been only a normal increase in business in 1916 and 1917 there would have been no substantial increase in operating income, and probably there would have been a further decline of it, and since the war ended the traffic has become smaller than it was in 1916.

THE DECLINE OF INVESTMENT

Did the decline in the percentage of return earned down to 1915 affect the amount of capital invested in the railroads? The new capital invested certainly declined during this period. The new investment made in 1910 was $778,000,000 and in 1911, the year in which the Commission first refused to grant a general advance in rates, it was $808,000,000. In 1912 it was only $680,000,000; in 1913, $478,000,000; in 1914, $584,000,000; in 1915, $311,000,000; and in 1916, $268,000,000. In 1916 the investment made was less than one-third what it was five years before. The statistics demonstrate that under the old system of regulation there was a rapid decline of investment in railroads; and it is certainly not unreasonable to assume that this was mainly due to the decline in the net return earned.

The natural resources of the United States are far from being fully developed. They ought to be much more fully developed. But the transportation machine has not sufficient capacity satisfactorily to handle the present commerce of the country. Its capacity ought to be doubled, tripled, quadrupled as time goes on. It seems to follow that our system of regulation should be so changed that it will be as much its purpose to promote the adequate development of transportation facilities as to protect the public from exploitation by the railway companies. It is a

remarkable fact that the former has never been one of its purposes in the past. Legislatures and commissions have been engaged for years in passing laws and issuing orders predicated on the principle that freight and passenger rates should be made as low as they can be without involving confiscation. The fact that adequate development of transportation facilities is more important to the country than extremely low rates, and that rates which are not confiscatory may nevertheless be so low as to stop the development of the railroads, has not been recognized or has been ignored by most of the regulating authorities. There can hardly be found a single word in any report or order of any regulating body indicating that it has considered it its function to stimulate the development of transportation facilities. The attitude of the regulating commissions has been the same as that of the regulatory laws. There probably cannot be found in any regulatory statute a single phrase indicating that it is any part of the purpose of regulation to promote the development of railroad transportation. Experience gives strong support to the suggestion that the law should be amended to provide that rates must be made sufficient to enable the railroads adequately to develop their facilities and that a Federal Transportation Board should be created, one of whose principal duties should be to certify to the Interstate Commerce Commission from time to time the amount of revenues that the railroads should in the public interest be allowed to earn.

REGULATION NOT A FAILURE

If the federal regulating authorities are to be given the responsibility and duty of so fixing rates as to enable the railway companies to earn adequate returns, the laws should be so framed as to prevent state authorities from interfering with them in performing this duty. Many state legislatures and commissions have in the past fixed rates which yielded the railways even smaller profits than those fixed by the Interstate Commerce Commission. The federal regulating authorities should be given power either to fix all rates, state and interstate, or to nullify any rate fixed by a state which would not pay as much as it should of the total cost of transportation.

The fact that the old system of regulation has had some bad

as well as some good effects by no means proves that regulation of railroads cannot be made a success. Effective regulation, and especially effective regulation by commissions, is a comparatively new policy, and has been hardly tried at all except in the United States and Canada. It was not reasonably to be expected that a complete success of it would be made from the start. If Congress will correctly appraise both the past failures and the past successes of regulation and the reasons for them, and change the old system as experience suggests it should, the new system of regulation may well prove a greater success than any other policy which the government could adopt in dealing with the railroads.